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TAGS: EFIN ECON RS
SUBJECT: RUSSIA CONSIDERING EXPENSIVE PATH TO FREE-FLOATING RUBLE

REF: MOSCOW 160

Classified By: ECON MC Eric T. Schultz, Reasons 1.4 (b/d).

¶1. (C) Summary. The ruble will almost certainly breach the level at which the Central Bank (CBR) has pledged to intervene to prevent further depreciation tomorrow. Experts are divided as to whether the Central Bank will implement its pledge to intervene. One school of thought holds that the ruble is near its equilibrium with the dollar/euro basket and that the CBR can successfully support the ruble with a minimal expenditures of reserves. However, a competing school maintains that in light of an increasingly bleak economic forecast, including heavy capital outflows and a steady, continuing drop in oil prices, the ruble will continue to decline, forcing the CBR to let the ruble float once it has exhausted its reserves. End Summary.

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Ruble Soon to Breach Upper Limit; Will Central Bank Intervene?
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¶2. (C) On January 22, CBR Chairman Ignatiev announced the end of the GOR's policy of "managed devaluation" with a 10 percent one-off relaxation of the ruble's band against its benchmark dollar/euro basket (reftel). Ignatiev said at the time that the CBR would defend the ruble against further depreciation if the currency breached RUB 41 to the basket. Just over a week after the announcement, the ruble has declined nearly 10 percent, reaching 40.6 to the basket at the end of today's trading.

¶3. (C) The ruble will almost certainly breach the CBR's RUR 41 to the basket limit tomorrow. In light of the ruble's accelerating depreciation, many analysts expect the CBR to intervene. Expectations are that the CBR will raise key interest rates as well as again use the country's dwindling foreign exchange reserves (now down to $386 billion) in open market operations to support the ruble. These analysts disagree, however, on the CBR's probability for success.

Pro: The ruble is near equilibrium

¶4. (C) Deutsche Bank Chief Economist Yaroslav Lissovolik is optimistic the CBR's efforts will maintain the ruble at the target RUR 41 to the basket, noting the ruble's depreciation of approximately 40 percent since August has brought the currency to an appropriate level in the current oil price environment. If the CBR limits the volume of ruble liquidity it provides to the banking sector while raising the interest

rate accordingly, pressure to use reserves to support the ruble will abate. Lissovolik sees no downside risk to the banking sector from this policy prescription; raising the borrowing terms on the CBR's short-term loans will discourage banks from continuing to speculate on the exchange rate, a factor which has recently held up the pace of bank lending to small and large corporations alike.

¶5. (C) Troika Dialog Chief Economist Yevgeniy Gavrileknov also believes that the ruble is now near its equilibrium, with the caveat that oil price stability will be vital to the CBR's success over the next few months. Now that the equilibrium exchange rate has been reached, Gavrilenkov maintains the use of reserves (to maintain confidence in the ruble) combined with a more aggressive monetary policy (i.e., higher interest rates) should allow a resumption of normal economic activity. Gavrilenkov also sees potential for the current ruble-basket rate to boost production through import substitution and through increased exports.

Contra: Defending the ruble will be too costly

¶6. (C) Other analysts are not so sanguine and believe the ruble has farther to fall as economic activity in Russia continues to slow. UralSib Chief Strategist Chris Weafer posits that the outlook for the Russian economy is not positive enough to sustain the current ruble-basket exchange rate. Although he concurs with the view that a change in CBR policy could dampen speculative pressure against the ruble, Weafer foresees a reconsideration of the CBR's ruble defense strategy once the level of reserves dwindles to USD 300 billion. With reserves below that level, he and other analysts believe that Russia risks a weakening of its investment grade rating, which would complicate future borrowing. Weafer also believes that, at the USD 300 billion mark, the CBR would likely return to gradual devaluations rather than either allow a float or risk rapidly drawing down its foreign exchange reserves.

¶7. (C) Royal Bank of Scotland Research Director for Central and Eastern European Emerging Markets Tim Ash believes the CBR is not likely to sustain its support for the ruble in light of other pressures on foreign exchange reserves. He forecasts a difficult capital account position for Russian in 2009, a prediction we have heard from other analysts, including former CBR Deputy Chairman Sergei Aleksashenko (below). Barring the availability of new sources of financing, Ash expects a strain on foreign reserves as public and private sector debt repayments of USD 117 billion (or more) come due this year. He concludes that the ruble-basket exchange rate will decline further.

¶8. (C) According to Higher School of Economics Professor, and former CBR Deputy Chairman, Sergei Aleksashenko, the reserves of the Central Bank exist for the express purpose of defending the ruble in a crisis. However, he concurs with Ash that a sustained defense of the ruble is unlikely in the present circumstances. Aleksashenko expects a difficult transition ahead for the Russian economy this year. Global changes in risk assessments have raised Russia's cost of capital and have resulted in reduced demand for the country's exports. The result is a declining trade balance, which, when combined with a highly negative capital account caused by large short-term debt repayments, may force the CBR to abandon market interventions to support the ruble. Instead, he predicted the CBR will have to allow the ruble to devalue further, perhaps to as much as RUR 45 to the dollar in order to slow imports and produce a current account surplus.

¶9. (C) Compounding policy makers' difficult choices, Russia will not garner much of an economic boost even if the currency were allowed to float freely. Aleksashenko notes the economy does not have the spare capacity that was available to it in 1998, allowing Russia to harness the depreciated ruble and export its way to prosperity. As a

case in point, Aleksashenko mentioned the president of Unimilk, Russia's second-largest dairy producer, told him that, even if the ruble devalued sharply, most Russian companies in the industry were in no position to expand production significantly in the near-term. The implication is that the ruble will have to fall significantly to have the needed effect on imports.

Comment

¶10. (C) In our view, the CBR's January 22 gamble has not paid off. For the sake of political expediency, the CBR will again be forced to use its remaining reserves in conjunction with tight monetary policy (which will slow growth further) to defend the ruble. However, economic indicators suggest the ruble has farther to fall as balance of payments pressures mount, which tells us the CBR will eventually have no choice but to let the ruble float, but probably not before it spends additional reserves trying to defend it and slow its depreciation. End Comment.
BEYRLE